

9

Supreme Court, U. S.

FILED

NOV 7 1995

No. 95-325

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

REORGANIZED CF&I FABRICATORS OF UTAH, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

BEST AVAILABLE COPY

10/17/95

TABLE OF AUTHORITIES

Cases	Page
<i>Aper Oil Co., In re</i> , 118 B.R. 683 (Bankr. E.D. Mo. 1990)	6
<i>Aztec Co., In re</i> , 107 B.R. 585 (Bankr. M.D. Tenn. 1989)	6
<i>Benjamin v. Diamond</i> , 563 F.2d 692 (5th Cir. 1977)	4
<i>Colley v. National Bank of Texas</i> , 814 F.2d 1008 (5th Cir.), cert. denied, 484 U.S. 898 (1987)	7
<i>Comstock v. Group of Institutional Investors</i> , 335 U.S. 211 (1948)	4
<i>Groetken v. Illinois Dep't of Revenue</i> , 843 F.2d 1007 (7th Cir. 1988)	2
<i>Husted, In re</i> , 142 B.R. 72 (Bankr. W.D.N.Y. 1992)	6
<i>Michelson v. Lesser</i> , 939 F.2d 669 (8th Cir. 1991)	6
<i>Pepper v. Litton</i> , 308 U.S. 295 (1939)	4
<i>S.G. Wilson Co. v. Cleanmaster Industries, Inc.</i> , 106 B.R. 628 (Bankr. 9th Cir. 1989)	7
<i>Schultz Broadway Inn v. United States</i> , 912 F.2d 230 (8th Cir. 1990)	6
<i>Seidle v. United States (In re Airlift International, Inc.)</i> , 120 B.R. 597 (S.D. Fla. 1990)	2
<i>Stebbins v. Crocker Citizens National Bank</i> , 516 F.2d 784 (9th Cir.), cert. denied, 423 U.S. 913 (1975)	4, 5
<i>Taylor v. Standard Gas & Electric Co.</i> , 306 U.S. 307 (1939)	4, 5
<i>United States v. Dividend Development Corp.</i> , No. SA CV 94-84 (C.D. Cal. Apr. 6, 1994), appeal pending, No. 94-55827 (9th Cir.)	3
<i>United States v. Juvenile Shoe Corp.</i> , 180 B.R. 206 (E.D. Mo. 1995), appeal pending, No. 95-2289 (8th Cir.)	3

IV

Cases—Continued:

	Page
<i>United States v. Mansfield Tire & Rubber Co.</i> , 942 F.2d 1055 (6th Cir. 1991), cert. denied <i>sub</i> <i>nom. Krugliak v. United States</i> , 502 U.S. 1092 (1992)	1, 2
<i>United States v. Unsecured Creditors' Committee</i> <i>of C-T of Virginia, Inc.</i> , 977 F.2d 137 (4th Cir. 1992), cert. denied, 113 S. Ct. 1644 (1993)	3
<i>United Steelworkers of America v. PBGC (In</i> <i>re Wheeling-Pittsburgh Steel Corp.)</i> , 103 B.R. 672 (W.D. Pa. 1989)	2
<i>Virtual Network Services Corp., In re</i> , 902 F.2d 1246 (7th Cir. 1990)	6

Statutes and rules:

Bankruptcy Code, 11 U.S.C. 101 <i>et seq.</i> :	
11 U.S.C. 103(a)	8
11 U.S.C. 502(j)	7
11 U.S.C. 507	3
11 U.S.C. 507(a)	5
11 U.S.C. 507(a)(7)(E)	1, 2, 9
11 U.S.C. 510(c)	3, 5, 7, 8
11 U.S.C. 1129(b)(1)	5
Internal Revenue Code (26 U.S.C.):	
§ 4971	1, 2, 3, 6, 7
§ 4975	3
§ 4980	3
Fed. R. Civ. P.:	
Rule 59	7
Rule 60	7

In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-325

UNITED STATES OF AMERICA, PETITIONER

v.

REORGANIZED CF&I FABRICATORS OF UTAH, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. a. Respondents do not dispute that a conflict among the circuits exists on the first question presented in this case. The decision of the Tenth Circuit in this case conflicts directly with the decision of the Sixth Circuit in *United States v. Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied *sub nom. Krugliak v. United States*, 502 U.S. 1092 (1992). In *Mansfield Tire*, the Sixth Circuit held that an excise tax claim under Section 4971 of the Internal Revenue Code is entitled to the priority afforded excise taxes under Section 507(a)(7)(E) of the Bankruptcy Code. 942 F.2d at 1059. In the present case,

the Tenth Circuit held precisely to the contrary. See Pet. App. 4a-6a.

b. Unable to dispute the existence of this direct conflict, respondents attempt to minimize its significance. They argue that the conflict is unimportant because, in their view (Br. in Opp. 12), the cases could have been resolved under the theory that Section 507(a)(7)(E) grants priority only to claims for excise taxes on a "transaction" and that Section 4971 does not impose an excise tax on a "transaction" (Br. in Opp. 12). That contention, however, was in fact considered and rejected by the Sixth Circuit in *Mansfield Tire*, 942 F.2d at 1059 n.4. Thus, even if the court of appeals had adopted respondent's additional contention, the direct conflict between the circuits would still exist.¹

c. Respondents concede (Br. in Opp. 15) that the question of the proper priority to be afforded to excise tax claims is litigated frequently. See, e.g., *Seidle v. United States (In re Airlift International, Inc.)*, 120 B.R. 597 (S.D. Fla. 1990); *United Steelworkers of America v. PBGC (In re Wheeling-Pittsburgh Steel Corp.)*, 103 B.R. 672 (W.D. Pa. 1989). Indeed, excise tax claims asserted under Section 4971 alone accumulate to hundreds of millions of dollars annually.

Moreover, the issue presented in this case has consequences well beyond the Section 4971 excise tax alone. Claims for other federal excise taxes have been

¹ The Sixth Circuit correctly rejected this contention in *Mansfield Tire*. As the petition notes (Pet. 13), Congress intended the priority for excise taxes to be comprehensive in scope. See also *Groetken v. Illinois Dep't of Revenue*, 843 F.2d 1007, 1013-1014 (7th Cir. 1988). The "transaction" taxed under Section 4971 is the act of maintaining a pension plan that is not funded adequately.

contested on the same ground that the court of appeals sustained in this case—that the tax is "punitive" and should therefore be denied the priority that Congress expressly provided for such claims in Section 507 of the Bankruptcy Code. See, e.g., *United States v. Juvenile Shoe Corp.*, 180 B.R. 206 (E.D. Mo. 1995), appeal pending, No. 95-2289 (8th Cir.) (excise tax under 26 U.S.C. 4980); *United States v. Unsecured Creditors' Committee of C-T of Virginia, Inc.*, 977 F.2d 137 (4th Cir. 1992), cert. denied, 113 S. Ct. 1644 (1993) (same); *United States v. Dividend Development Corp.*, No. SA CV 94-84 (C.D. Cal. Apr. 6, 1994), appeal pending, No. 94-55827 (9th Cir.) (excise tax under 26 U.S.C. 4975).

When excise tax claims are denied priority, they are paid along with general unsecured claims, typically at a fraction of their face value. And when, as in the present case, such claims are further subordinated to the claims of general unsecured creditors, the excise tax claims are paid nothing at all. The priority scheme that Congress enacted for excise tax claims is thereby entirely nullified by the decision in this case.

2. The second question presented in the petition is whether principles of equitable subordination codified in Section 510(c) of the Bankruptcy Code permit subordination of an excise tax claim in the absence of inequitable conduct by the government in obtaining or enforcing the claim.

a. Respondents err in contending that the decision in this case does not conflict with the decisions of this Court or of other circuits. This Court long ago held that bankruptcy courts may use their equitable powers to subordinate claims that creditors acquired or asserted in violation of fiduciary duties or by other-

wise acting inequitably and to the detriment of other creditors. *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939); *Pepper v. Litton*, 308 U.S. 295 (1939); *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948). In the *Comstock* case, the Court made clear that equitable subordination may *not* also be used to subordinate legitimate claims of innocent creditors (335 U.S. at 229):

It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong. On the findings in this case, the claim of [the parent] was the outgrowth of complicated but legitimate good faith business transactions, neither in design or effect producing injury to the petitioner or the interests for which he speaks.

Several of the courts of appeals have likewise recognized that "creditor misconduct" must exist for the doctrine of equitable subordination to apply. See *Benjamin v. Diamond*, 563 F.2d 692, 699-700 (5th Cir. 1977); *Stebbins v. Crocker Citizens National Bank*, 516 F.2d 784, 788 (9th Cir.), cert. denied, 423 U.S. 913 (1975). Respondents' sole basis for suggesting that these decisions do not conflict with the decision below—which subordinates the legitimate statutory claim of a blameless creditor—is that decisions such as *Comstock*, *Benjamin*, and *Stebbins* did not address whether a statutory "penalty" claim might be subordinated under principles of equitable subordination. But the enforcement of a statutory claim, enacted to *prevent* misconduct by the debtor, cannot plausibly be

regarded as misconduct by the creditor.² Respondents thus err in suggesting that the decision in this case does not conflict with the preexisting holdings of this Court and of other circuits.

Section 510(c) of the current Bankruptcy Code did no more than codify preexisting "principles of equitable subordination." Prior to the enactment of Section 510(c), decisions such as *Comstock*, *Benjamin*, and *Stebbins* had firmly established that equitable subordination is not a license to subordinate on the basis of "abstract legislative judgments about * * * fairness" (*Stebbins v. Crocker Citizens National Bank*, 516 F.2d at 787). By holding that equitable subordination may apply even in the absence of a "showing of inequitable behavior" (Br. in Opp. App. 4a), the decision in the present case contradicts and conflicts with that established principle.

b. Respondents advance a new contention that was not raised in the bankruptcy court or the district court and, although raised in the court of appeals, was not considered or addressed by that court. Respondents' new contention is that subordination of the government's claim might have been achieved in the present case *without* invoking principles of equitable subordination, by applying other provisions of the Bankruptcy Code. They contend (Br. in Opp. 13-15, citing 11 U.S.C. 1129(b)(1)) that the bankruptcy court *could* have confirmed their plan of reorganization, over the government's objection, solely upon a finding

² The fact that the creditor who asserts such a claim has not contributed to the estate is also irrelevant. Many claims are granted priority without regard to whether the claimant can establish that it has contributed assets to the estate. See 11 U.S.C. 507(a).

that it was "fair and equitable" and did not "discriminate unfairly" to treat the Section 4971 claim worse than general unsecured claims.

Of course, the courts below were not requested to—and did not—make a finding that, in the absence of equitable subordination, it would be "fair and equitable," and would not "discriminate unfairly," to omit payment of the government's claim. Instead, the court's finding that these statutory standards would be met was premised on the assumption that the government's claim was properly subject to equitable subordination (Pet. App. 28a; Br. in Opp. 17). Whether the court would have made a finding that subordination of a claim that was *not* subject to equitable subordination would satisfy these statutory standards, and what relevance such a finding might have if it had been made, are issues that this case clearly does not present. The unsupported theory that respondents belatedly seek to inject in this case has not been adopted by any court.³ In particular, the court of

³ The statutory term "unfair discrimination" is not defined in the Bankruptcy Code. Attempts to devise a definition have produced a variety of results. See, e.g., *Michelson v. Lesser*, 939 F.2d 669, 672 (8th Cir. 1991); *In re Aztec Co.*, 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989); *In re Husted*, 142 B.R. 72, 74 (Bankr. W.D.N.Y. 1992). None of the decisions applying that term has subordinated a statutory penalty claim. Instead, when statutory penalty claims have been subordinated, courts have relied on the "principles of equitable subordination" that the present case involves. See, e.g., *In re Apex Oil Co.*, 118 B.R. 683, 694-699 (Bankr. E.D. Mo. 1990). See also *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990).

appeals did not refer to it—much less rely on it—in this case.⁴

Instead, the court applied the "principles of equitable subordination" codified in Section 510(c) of the Code in a manner that nullifies the priority structure that Congress enacted. The conflict that exists among the courts of appeals on the proper meaning of the "principles of equitable subordination" codified in Section 510(c) of the Bankruptcy Code merits this Court's review.

c. Respondents suggest (Br. in Opp. 15) that "unique facts" and "unusual circumstances" make the present case inappropriate for consideration of the equitable subordination issue. They refer to a statement of the bankruptcy court (Br. in Opp. App. 5a) that allowing the Section 4971 excise tax claim on a par with general unsecured claims would reduce the amount available for distribution to holders of general unsecured claims, some of whom the bankruptcy court regarded as more worthy of payment (Br. in Opp. App. 3a-5a).

There is obviously nothing unique or unusual about the fact that, under a subjective scheme of valuation,

⁴ Respondents also err in suggesting (Br. in Opp. 14) that the bankruptcy court could have subordinated the excise tax claim under the authority provided in Section 502(j) of the Bankruptcy Code to reconsider claims (11 U.S.C. 502(j)). This is another provision that respondents did not seek to invoke in the bankruptcy or district courts. In any event, Section 502(j) is simply an analogue of Rules 59 and 60 of the Federal Rules of Civil Procedure. It authorizes bankruptcy courts to reconsider the allowance or disallowance of a claim where "the equities of the case" justify reconsideration. See *Colley v. National Bank of Texas*, 814 F.2d 1008, 1010 (5th Cir.), cert. denied, 484 U.S. 898 (1987); *S.G. Wilson Co. v. Cleanmaster Industries, Inc.*, 106 B.R. 628, 630 (Bankr. 9th Cir. 1989).

some claims will appear more worthy than others. That type of personal, individualized reaction to the "worthiness" of competing claims lies at the heart of the issue that this case presents for review. This case squarely presents the question whether "principles of equitable subordination" authorize a bankruptcy court to make a subjective assessment of the relative merits of the legitimate claim of an *innocent* creditor and, based on that assessment, subordinate the claim to other claims that Congress provided should be given parity or lower priority in the statutory scheme.

3. We have suggested that, if the petitions in this case and *United States v. Noland*, No. 95-323, are both granted, the two cases should be set for argument in tandem because they present closely related questions concerning the proper scope of equitable subordination. Respondents, however, dispute that the issues are closely related, noting that *Noland* arises under Chapter 7 of the Bankruptcy Code and that this case arises under Chapter 11 (Br. in Opp. 16). That distinction, however, makes no difference for application of the principles of equitable subordination codified in Section 510(c), which are to apply alike in cases under both Chapters. See 11 U.S.C. 103(a).

Respondents correctly note (Br. in Opp. 16) that the *Noland* case involves the subordination of a statutory claim that the court acknowledged *is* entitled to priority under the statutes enacted by Congress. In the present case, by contrast, the court of appeals held that the statutory claim was *not* within the statutory priority category. That difference is the reason why *Noland* and the present case should be heard in tandem; neither case individually would

require the Court to address all of the issues raised by the two cases together.⁵

* * * * *

For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

NOVEMBER 1995

⁵ *Noland* does not present the first question presented in this case—the scope of the priority granted in Bankruptcy Code Section 507(a)(7)(E).